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EEC/USA MONETARY RELATIONS

The dominant factor in the monetary relations between the Community and the United States has been the reform of the international monetary system against a background of heavy dollar fluctuations in the exchange markets.

Since 1978, when the creation of a European monetary system (EMS) was first mooted and after its introduction in March 1979, monetary relations between the Community and the United States have been marked by a certain amount of tension, which was further aggravated by the downward slide of the American currency in October 1978 and in 1979.

I. FACTORS IN THE INTERNATIONAL MONETARY CRISIS

1. The break-up of the Bretton Woods system

The monetary system set up at the end of the war, by the BRETTON WOODS agreement came to an end on 15 August 1971 when President Nixon suspended the convertibility of the dollar. Fifteen years of masked crises and gathering clouds preceded the death of the old international monetary system. But the Bretton Woods system, which was based on convertibility of the dollar into gold, fixed parities and international monetary cooperation was not to disappear officially until the adoption of the new Articles of the International Monetary Fund (IMF) in September 1976.

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- The crisis was, primarily, the result of the growing deficit in the American balance of payments, a deficit which was gradually eroding the dollar and in 1968 unleashed an overt world monetary crisis: in that year the United States abolished gold convertibility of the dollar for private individuals. The de facto inconvertibility of the currency was made official in 1971, when it was applied to central banks as well. Despite the Washington agreements of December 1971 comprising a general realignment of exchange rates, and notably a decrease in the dollar's gold parity, confidence in the international monetary arrangements was not restored and the dollar was once more devalued in February 1973.

Strong speculative movements, which had already forced major exchange rate modifications for most currencies in 1973, have been sweeping the exchange markets at more or less regular intervals ever since.

- The break-down of the Bretton Woods monetary system was also due to the non-functioning of the parity adjustment process. On the one hand the United States had too long remained in fundamental deficit while the Administration refused to devalue the currency; this policy, which experts had condemned since the early 1960s, could only be pursued through automatic financing of the deficit, made possible by the dollar's role as a reserve currency. On the other hand, certain countries with balance of payments surpluses refused to acknowledge the appreciation of their currency while they strove to neutralize the monetary effects of their surplus position. The Bretton Woods system, therefore, succumbed to the rigor mortis of an excessively rigid parity adjustment process.

- After 1973 the pendulum gradually swung to the opposite extreme and stuck there. Generalized floating has become the principal characteristic of the world monetary 'non-system' since 1971. It is a 'non-system' which, since the adoption of the draft of the second amendment of the Articles of Agreement of the IMF in 1976 in Jamaica, operates on the following four principles:

(1) since overall flexibility of exchange rates is a dangerous illusion which must be dispelled, the new provisions in the Articles do not constitute a legal basis for permanently floating exchange rates;

(2) the objective is to introduce a system of stable but adjustable exchange rates. All Fund members should decide on an exchange rate for their currency and maintain that rate within the limits of an acceptable margin;

(3) however, a transition period is required to prepare a satisfactory introduction of the new system which cannot come into force until the world economy has recovered adequate stability;

(4) finally, if an international monetary system is to be respected, this implies increased powers for the IMF.

2. Europe and the dollar

In 1945, the dollar was all-powerful: convertible without difficulty in view of the large stocks of gold built up by the United States, it was all the more sought after because there was widespread poverty and America alone could supply the goods necessary for the survival and reconstruction of countries ruined by the war.

At the same time, in consequence of the Bretton Woods decisions, the dollar was rapidly coming to dominate the world monetary system.

In contrast, the European countries emerged from the war in a disastrous monetary state: inconvertible and depreciating currencies, inflation, shortage of gold and currency reserves forced them to apply exchange controls, slowed down their recovery, and made them dependent on American aid.

Beginning with the 1950s, several factors combined to effect a transition from a world shortage of dollars to a growing abundance of that currency: the rapid recovery of the economies of Western Europe and Japan, the 1949 devaluation of most European currencies with respect to the dollar, the undertaking by the United States of a huge programme of foreign economic or military aid and the fast growth of private investment, particularly of direct American investments abroad.

The American BOP deficit, which gave no cause for concern in the period 1950-1960, now began to pose a threat to the smooth functioning of the international monetary system.

Between 1960 and 1973 the dollar crisis remained at the centre of the monetary relations between Europe and the United States, especially as regards the member countries of the European Economic Community. The central banks of these countries were accumulating increasing dollar reserves as the United States continued to make massive direct investments in the Common Market. Most of these countries, nevertheless, supported the American view that the official dollar parity, the pivot of the international monetary system, was sacrosanct.

Divergencies in views and policies between France and its remaining Common Market partners throughout this period affected the development of the Community, and especially any initiative to set up monetary cooperation among the Member States. To many, any such initiative seemed like a more or less veiled declaration of war against the dollar. Instead of acting together, the Common Market countries confined themselves ~~of~~ to more or less uncoordinated measures and it was not until the dramatic events of August 1971 that they managed to achieve a common position for the negotiations leading to the Smithsonian Agreement, and that they made the first steps towards ordering intra-Community monetary relations.

On 11 March 1973, six European Community member countries decided to float their currencies together and to stop maintaining their dollar exchange rates.

The dollar, since 1971, has suffered repeated exchange fluctuations and since 1978 it has been sliding so severely that fears had been expressed of the approach of a world monetary and economic crisis as serious as that of 1929.

In the face of this deteriorating international monetary situation, and especially of the congenital weakness of the international currency represented by the dollar, the European Economic Community attempted a number of, mostly unsuccessful, measures between 1971 and 1978 before finally setting up the EMS in 1979.

II. THE EUROPEAN POSITION

1. Monetary situation in Europe before the Jamaica agreement

This period can be subdivided into the stages of infancy, achievement and doubt.

(a) From the signing of the Treaty of Rome to The Hague Conference of 1969, the European Economic Community made virtually no progress in its efforts to coordinate monetary matters.

(b) At the 1969 Hague Conference the Heads of State and of Government declared for the first time that they were resolutely in favour of the achievement in stages of an economic and monetary union. There was set up a committee of experts which was eventually to produce the Werner plan; however, the crisis of May 1971 and the American move of 15 August of that year, were destined to delay the practical implementation of the provisions proposed in the Werner plan and of the Council decisions of March 1971.

After the Washington agreement a Council resolution of March 1972 opened the way to narrowing the margins of fluctuations between Community currencies and to the establishment of a European Monetary Cooperation Fund (EMCF).

(c) The period of doubt. The floating of sterling and of the Italian lira, followed by that of the French franc, made the conduct of the Common Agricultural Policy increasingly complex. What is more, differences of attitudes to international monetary problems began to appear among the Community Member States.

On the question of the future exchange rate system, there were traditional differences of attitude among the Member States, some opting, with the United States, for flexibility, others for fixed parities. They also could not agree on the role of gold and on the choice between a unified world monetary system and a multi-polar one.

It should be noted here that these conflicts were attentuated after 1974, and that since that time the Community countries have tended to coordinate their activities within the IMF and, after Kingston, have managed to defend their common position vis-à-vis the Fund.

2. The monetary situation in Europe from the Kingston meeting to the creation of the EMS

There have been a number of developments in the European monetary situation since Kingston. The European monetary 'snake' did become operative, but it gradually shrank to a 'DM area'. In addition, a system of Community loans to finance oil deficits was introduced.

Then, a new European unit of account (EUA) was created and, above all, the economic and monetary union was relaunched with the establishment of a European Monetary System (EMS) which came into force in March 1979.

3. The EMS

(a) The reason for the creation of the European Monetary System

The main objective of the EMS is to create a zone of monetary stability in Europe and thus to promote economic growth and improve the employment situation in the European Community. There is a good deal of misunderstanding of this fundamental aim, particularly in the United States, where there is a tendency to regard it as being directed against the dollar.

It seems necessary, therefore, to clarify the real motives behind the creation of the European Monetary System:

- the debatable motives:

One of these is said to be the protection of Europe, with its trade and its economic interests, from the effects of the chaotic fluctuations of the dollar rate. On this interpretation, widely discussed in the specialist press, especially in the United States, the EMS would represent a system of defences set up by the European Economic Community.

The EMS is neither a citadel to shield the Community from the erratic movements of the dollar, nor a battering ram aimed at the American currency. If the European currencies overall gain in value with respect to the dollar, this does not protect the Community from the deleterious effects of the latter's depreciation, two of which are of major importance: the distrotion of competition to the benefit of American producers, and a perpetual incentive to the producers of raw materials to raise their prices, which are expressed in dollars, to compensate for the latter's falling value.

Nor can it be regarded as a weapon aimed at the dollar because, whatever the European monetary set-up, it must fit into the wider framework of the international monetary system.

All this means that if Europe failed to coordinate its policies with those of its partners, and especially of the United States, the existence of the EMS was likely to undermine further the position of the dollar.

- <u>the convincing motives</u>:

There are two: the first is that fixed exchange rates among the Community currencies will promote the development of intra-Community trade. In an area of such dynamic economic activity, where, thanks to the elimination of customs duties and non-tariff obstacles to trade, there is something approaching optimum allocation of the factors of production, it is difficult to adjust to parity changes such as have occurred between the 'snake' countries and Germany on the one hand and France and Italy on the other. This is the principal reason behind the EMS.

The second, less obvious but no less important, reason is undoubtedly the contribution which the EMS can make to the establishment of an orderly world economic system.

The Jamaica agreements have in fact not filled the vacuum left by the break-up of the Bretton Woods international system.

In a well-ordered world monetary system it should be possible, first of all, to effect payments across frontiers and secondly, but here lies the rub, there should be a mechanism for offsetting debtor and creditor balances which the countries concerned would be obliged to apply and which yet would not jeopardize their freedom in internal policies.

The world's six-year-old experience with flexible exchange r rates shows that these do not meet either of the requirements for a satisfactory world monetary order.

The second reason behind the EMS, therefore, is that through t the pragmatic evolution of effective and equitable rules for monetary behaviour between neighbouring countries linked by economic and cultural links, progress should be made towards creating a world monetary order.

III. CURRENT SITUATION

1. American monetary policy

American policy in the monetary field since 1969 has been marked by a series of stop-go measures. Coupled with that country's policy on energy and the American anti-inflationary programme, these explain why the dollar's position has been so seriously shaken.

Since 1 November 1978, however, the United States seems to have found the right direction for its monetary policy. The measures announced by President Carter that day represent a radical swing away from earlier policies: first, the United States decided to borrow not only from central banks but also in the private market and, secondly, they accepted that these loans should no longer be denominated only in dollars, but also in the currency of the creditor country: marks, Swiss francs, yens. These measures helped to restore calm to the world money markets for a period of six months. But it was not to last. From June 1979, following the increase in oil prices and the announcement that inflation in the United States was getting worse, speculation against the dollar increased, together with its corollary, rising gold prices.

On 6 October 1979, faced with a slumping dollar and spiralling gold, the US Federal Reserve Board decided to introduce a new series of measures: discount rate up from 11 to 12%, banks required to create supplementary reserves in proportion to increased liabilities (time deposits, Euro-dollar borrowing, Federal State funds), and a new market intervention strategy in which the Federal Reserve gives priority to controlling the money supply.

The new American policy was welcomed by the Europeans, who were quick to note in it the first implicit recognition by the United States that the dollar's weakness is primarily due to internal causes, and welcomed the major switch in the philosophy of the Federal Reserve which for a long time before had made the control of short-term interest rates its principal objective.

Now, control of the money supply takes pride of place and interest rates will follow fluctuations in demand. In the last resort the effectiveness of these measures will depend on the resolve with which the American authorities are prepared to implement them.

The fact that the Americans now see the defence of their currency as the principal task can only please the Europeans who have no desire to go on supporting the dollar by themselves. Fears, however, are already being expressed that the new package is likely to depress economic growth in the United States, and therefore also in Europe.

2.1 The EMS vis-à-vis the dollar

The tribulations of the dollar in recent months have shown with increasing clarity that the crisis of the American currency is also a European problem. Most of the dollar crises put heavy pressures on European exchange markets, causing variations among the European currencies' exchange rates. In other words, the dollar crises trigger off the consequences of a problem which is specifically European: the lack of adequate coordination among the various monetary authooities.

Here we have a measure of the gravity of the situation in which the European Monetary System finds itself. Unless there can be a Community policy vis-à-vis the dollar, the flight from that currency will create constant pressures on intra-European exchange rates, and lead to the eventual collapse of the EMS.

The logic of maintaining a limited stability of exchange rates within a major geographical and economic zone has at last been recognised: such limited stability cannot be maintained without intervention in respect of third currencies, notably the dollar and the yen.

The Community member countries will thus have to set themselves target exchange rates for the dollar and the yen, and this major political decision will be a gauge of their desire for independence, but also of their willingness to cooperate with theirr two major partners, the United States and Japan.

If the United States managed to put its economic house in order, and so stabilize its currency, it will recreate the essential factor for a return to mutual confidence, a confidence which is a necessary condition for cooperation in monetary matters. If the Americans are successful in this endeavour, they have nothing to fear from the existence of the EMS;

3. <u>The reform of the international monetary system between 1978 and 1979</u>

The floating of currencies which first took place in March 1973 was officially sanctioned when on 1 April 1978 the Second Amendment of the Articles of Agreement of the IMF, whereby the Member States are free to choose their exchange arrangements, came into force. On the other hand neither the commitment undertaken by the countries concerned to abide by an 'orderly' and 'stable' system, nor the powers of surveillance over its members' exchange policies conferred on the Fund, have any real binding force.

At each of the meetings of the IMF Interim Committee (in Mexico at the end of April 1978 and in Washington at the end of September 1978) the Community was able to present a joint position laid down by the Council after discussions in the Monetary Committee. Thus the decisions on the quota increases, the new allocation of SDRs and the enhanced status of this instrument with a view to its becoming a medium of international settlements, were all made with the support of the European Economic Community.

Finally, at the IMF annual meeting on 5 October 1979 in Belgrade, the Community took an active part in the discussions preparatory to the creation of a 'substitution account' whereby dollars can be exchanged for special drawing rights (SDR). The Nine are, in principle, not opposed to the idea of this mechanism and they support the proposal that details of the provisions necessary to create this 'account' should be further studied.

But the European authorities attach anspecial importance to:
- means of ensuring that assets denominated in SDRs offer attractive yields,
- the maintenance of their value and the sharing of the burden of possible losees, as well as the question of the redemption of liabilities on this account,

- to the transferability and the liquidity of these assets.

By the terms of the agreement of 5 December 1978, the existence of the EMS is and remains totally compatible with the Articles of the IMF. Nevertheless, the fact that third countries may join the system, the role conferred on the ECU and its proposed extension to become a means of payment, as well as the retention of gold as the medium of payment in intra-Community settlements, already demarcate the EMS from the international monetary system.